

Fairness in Securities Arbitration: A Constitutional Mandate?

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Calls for reform of the securities arbitration process are not new. Since the Supreme Court decided *Shearson/American Express v. McMahon*¹ and *Gilmer v. Interstate/Johnson Lane Corp.*,² the use of arbitration to resolve customer-broker and employment disputes within the securities industry has expanded dramatically.³ Anyone who trades with a brokerage or works in the securities industry has agreed, as a condition of doing business or working, to arbitrate disputes that arise in the course of their relationship.⁴ Not surprisingly, not all customers or securities employees are enamored with the securities arbitration process. Anti-arbitration proponents often characterize the very advantages of arbitration—its streamlined procedures, speed and confidentiality—as problematic. Streamlined procedures and speed may disproportionately impact the customer or employee who had little if any bargaining power

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1. 482 U.S. 220 (1987).

2. 500 U.S. 20 (1991).

3. Daniel Q. Posin, *Literature Review: An Appraisal of Securities Arbitration*, 13 WORLD ARB. & MEDIATION REP. 246 (2002) (Supreme Court arbitration cases "spawned the flowering of industry-specific pre-dispute arbitration agreements [especially in the securities field]"); Norman S. Poser, *Judicial Review of Arbitration Awards: Manifest Disregard of the Law*, 64 BROOK. L. REV. 471, 499 (1998) ("With the inception of mandatory securities arbitration in 1987 The caseload of the NASD and the other arbitration forums increased enormously . . ."). In 1986, before the *McMahon* decision, only 1,587 customer-broker and employment disputes were filed with NASD. In 2004, NASD reported the filing of 8,201 customer-broker and employment disputes. See NASD Dispute Resolution, Dispute Resolution Statistics, http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW011183 (last visited Oct. 5, 2005).

4. *General Accounting Office Study 2000: Securities Arbitration on Review*, SEC. ARB. COMMENTATOR, Sept. 2000, at 3 (stating that "six of the nine responding broker-dealers now require individual investors to sign PDAAs [pre-dispute arbitration agreements] as a condition of opening some or all types of retail cash accounts. Eight of the nine require PDAAs for options accounts and all nine require the provision for margin accounts.").

when negotiating the initial agreement. Confidentiality suggests surreptitious and underhanded tactics swept under the rug.⁵ With little empirical support, critics of the use of pre-dispute arbitration agreements, both within and outside of the securities industry, began an attack in the mid-1990s to unseat arbitration as a popular mechanism for dispute resolution both among employers and employees and businesses and consumers.

The attack on arbitration in the securities industry has taken different forms over time. First, plaintiffs asserted a type of jurisdictional challenge, claiming that statutory claims, such as discrimination, fell outside the scope and power of industry arbitration agreements.⁶ Repeated failure of that claim precipitated a redirection of effort. Today, challenges to arbitration primarily focus on contractual theories, particularly unconscionability.⁷ These challenges have been relatively unsuccessful within the securities industry. Therefore, critics of arbitration have sought other means for challenging arbitration clauses and, as a result, began leveling constitutional attacks against arbitration in all its forms.⁸ This article will focus specifically on securities

5. Several courts have found that a confidentiality provision in an arbitration agreement is unconscionable because such provisions favor the repeat participant in the arbitration process by making it difficult to determine whether the arbitrator or the arbitration process was biased. Moreover, courts find that the lack of public disclosure of arbitration results may favor repeat players over individuals. *See* *Ting v. AT&T*, 319 F.3d 1126 (9th Cir. 2003); *Plaskett v. Bechtel Int'l, Inc.*, 243 F. Supp. 2d 334 (D.V.I. 2003); *Acom v. Household Int'l Corp.*, 211 F. Supp. 2d 1160, 1171-72 (N.D. Cal. 2002); *Luna v. Household Int'l Corp.*, 236 F. Supp. 2d 1166 (W.D. Wash. 2002).

6. *See, e.g., Gilmer v. Interstate/Johnson Lane Corp.*, 500 U.S. 20 (1991) (rejecting such a claim).

7. Unconscionability is the primary means used to challenge employer or business-drafted arbitration agreements. Courts have been fairly receptive to these challenges, striking down arbitration agreements as unconscionable where class actions are prohibited, where an employee must pay an arbitrator's fees or a high filing fee, or where the arbitral process is skewed in favor of the employer or business. *See, e.g., Morrison v. Circuit City Stores, Inc.*, 317 F.3d 646 (6th Cir. 2003); *Hooters of Am., Inc. v. Phillips*, 173 F.3d 933 (4th Cir. 1999); *Cole v. Burns Int'l Sec. Servs.*, 105 F.3d 1465 (D.C. Cir. 1997); *Brower v. Gateway 2000, Inc.*, 676 N.Y.S.2d 569 (N.Y. App. Div. 1998).

8. *See* Richard C. Reuben, *Constitutional Gravity: A Unitary Theory of Alternative Dispute Resolution and Public Civil Justice*, 47 UCLA L. REV. 949, 1049 (2000); Edward Brunet, *Arbitration and Constitutional Rights*, 71 N.C. L. REV. 81, 109 (1992); Kenneth R. Davis, *Due Process Right to Judicial Review of Arbitral Punitive Damages Awards*, 32 AM. BUS. L.J. 583 (1995); Jeffery L. Fisher, *State Action and the Enforcement of Compulsory Arbitration Agreements Against Employment Discrimination Claims*, 18 HOFSTRA LAB. & EMP. L.J. 289, 295-96 (2000); Jean Sternlight, *Rethinking the Constitutionality of the Supreme Court's Preference for Binding Arbitration: A Fresh Assessment of Jury Trial, Separation of Powers, and Due Process Concerns*, 72 TUL. L.

arbitration and consider whether constitutional challenges to arbitration in the securities industry are a viable means for obtaining needed reform of the securities arbitration process.

A necessary prerequisite for constitutional challenges to securities arbitration is a theory under which arbitration constitutes state action. Constitutional prohibitions, after all, apply only to state action.⁹ If state action arises when a plaintiff is required to use the securities arbitration process, that process must satisfy the constitutional requirements of due process and equal protection. Because a finding of state action would have significant, and likely adverse, implications on the continued use of arbitration as the means for resolving securities-related employment disputes, a careful consideration of whether state action is present in securities arbitration is necessary.

Courts have had several opportunities to address the broader question of whether judicial enforcement of arbitration agreements rises to the level of state action as well as the more narrow question of whether securities arbitration involves state action. Every federal court considering either question has concluded that there is no state action present in either securities or contractual arbitration.¹⁰ Although few

REV. 1 (1997).

9. The Constitution applies to non-governmental actors in some situations. For example, the Thirteenth Amendment to the Constitution prohibits all people from owning or being slaves. U.S. CONST. amend. XIII, § 1.

10. *Perpetual Secs., Inc. v. Tang*, 290 F.3d 132, 137-39 (2d Cir. 2002); *Koveleskie v. SBC Capital Mkts., Inc.*, 167 F.3d 361, 368-69 (7th Cir. 1999); *Desiderio v. Nat'l Ass'n of Secs. Dealers, Inc.*, 191 F.3d 198, 206-07 (2d Cir. 1999); *Lodal v. Home Ins. Co. of Ill.*, No. 95-2187, 1998 WL 393766, at *6 (6th Cir. 1998) (unpublished table decision); *Duffield v. Robertson Stephens & Co.*, 144 F.3d 1182, 1200-02 (9th Cir. 1998); *United Food & Commercial Workers Union v. Safeway, Inc.*, No. 98-15148, 1998 WL 904719 at *1 (9th Cir. Dec. 23, 1998) (unpublished table decision); *Davis v. Prudential Secs., Inc.*, 59 F.3d 1186, 1190-92 (11th Cir. 1995); *Fed. Deposit Ins. Corp. v. Air Fla. Sys., Inc.*, 822 F.2d 833, 842 n.9 (9th Cir. 1987); *Elmore v. Chi. & Ill. Midland Ry. Co.*, 782 F.2d 94, 96 (7th Cir. 1986); *Dluhos v. Strasberg*, No. 00-CV-3163, 2001 WL 1720272, at *5, *11 (D.N.J. Aug. 31, 2001), *aff'd in part*, 321 F.3d 365 (3d Cir. 2003); *Century Aluminum of W. Va., Inc. v. United Steelworkers of Am.*, 82 F. Supp. 2d 580, 583 n.4 (S.D. W. Va. 2000); *D'Alessio v. NYSE*, 125 F. Supp. 2d 656, 659 (S.D.N.Y. 2000); *Brannon v. Mass. Mut. Life Ins., Co.*, No. CIV A. 99-3497, 2000 WL 122241, at *5 (E.D. La. Jan. 31, 2000); *Mooring-Brown v. Bear, Stearns & Co.*, No. 99 Civ. 4130 JSR-HBP, 2000 WL 16935 (S.D.N.Y. Jan. 10, 2000); *Martens v. Smith Barney, Inc.*, 190 F.R.D. 134, 137-38 (S.D.N.Y. 1999); *McDonough v. Equitable Life Assurance Soc'y of the United States*, No. 98 Civ. 3921(BSJ), 1999 WL 731424, at *3 n.4 (S.D.N.Y. Sept. 20, 1999); *Mantle v. Upper Deck Co.*, 956 F. Supp. 719, 734-35 (N.D. Tex. 1997); *Cremin v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 957 F. Supp. 1460, 1465-70 (N.D. Ill. 1997); *Glennon v. Dean Witter Reynolds, Inc.*, No. 3-93-0847, 1994 WL 757709, at *10, *13 (M.D. Tenn. Dec. 15, 1994); *Cort v. Am. Arbitration*

commentators have considered whether securities arbitration involves state action,¹¹ the majority of commentators considering whether state action is present in contractual arbitration have concluded that state action is present.¹² While I have explored this fascinating dichotomy elsewhere,¹³ this article will focus on a narrower question—whether securities arbitration involves state action.

Part I of this article will describe the relationship between the SEC and the self-regulatory organizations (SROs) in order to determine whether state action is present in securities arbitration and, if so, how the process should be reformed to satisfy constitutional requirements. In Part II, the article will outline the Supreme Court's state action jurisprudence and then apply it to the case of securities arbitration, analyzing whether the SEC's involvement in the SRO arbitration process transforms the private SROs that directly administer the arbitration process into state actors for purposes of arbitration. While this is a complicated question, this section concludes that SROs are state actors when they require employees to participate in arbitration of employment disputes. In Part III, the article will consider whether the Equal Protection Clause is violated when a party to a securities arbitration strikes an arbitrator for discriminatory reasons. This section concludes that discriminatory strikes are actionable under the equal protection theory the Supreme Court articulated in *Batson v. Kentucky*¹⁴ and *J.E.B. v. Alabama ex rel. T.B.*¹⁵ In Part IV, the article addresses the question of

Ass'n, 795 F. Supp. 970, 973 (N.D. Cal. 1992); *Austern v. Chi. Bd. Options Exch., Inc.*, 716 F. Supp. 121, 125 (S.D.N.Y. 1989); *In re Knepp*, 229 B.R. 821, 840-41 (Bankr. N.D. Ala. 1999) (following Eleventh Circuit law despite disagreement regarding arbitration as state action). No state courts have found state action in contractual arbitration. *See, e.g.*, *Hadelman v. Deluca*, 876 A.2d 1136, 1138 (Conn. 2005). Only one state court suggests that a state action finding is possible. *See Williams v. O'Connor*, 310 N.W.2d 825, 826 (Mich. Ct. App. 1981). One federal district court states in *dicta* that it "respectfully doubts that the rationale for the result set forth in *Davis* . . . that an arbitration award involves no state action is well-founded." *Commonwealth Assocs. v. Letsos*, 40 F. Supp. 2d 170, 177 n.37 (S.D.N.Y. 1999) (citing *Davis*, 59 F.3d at 1191).

11. *See, e.g.*, Stephen J. Ware, *Punitive Damages in Arbitration: Contracting Out of Government's Role in Punishment and Federal Preemption of State Law*, 63 FORDHAM L. REV. 529, 559-67 (1994).

12. Brunet, *supra* note 8, at 109; Davis, *supra* note 8; Fisher, *supra* note 8, at 295-96; Reuben, *supra* note 8, at 991; Sternlight, *supra* note 8, at 40. *But see* Sarah Rudolph Cole, *Arbitration and State Action*, 2005 BYU L. REV. 1 (2005); Stephen J. Ware, *Punitive Damages in Arbitration: Contracting Out of Government's Role in Punishment and Federal Preemption of State Law*, 63 FORDHAM L. REV. 529, 559-67 (1994).

13. Cole, *supra* note 12.

14. 476 U.S. 79 (1986).

15. 511 U.S. 127 (1994).

whether SROs, by requiring employees to participate in the arbitration process, have denied them a property interest without due process. Only where a state actor denies a person a liberty or property interest may that person challenge the action of the state actor for failure to satisfy the requirement of the Due Process Clause. This section concludes that the right to have one's employment claim heard in the forum of one's choosing is a property interest. Finally, in Part V, the article considers how to modify the securities arbitration process to satisfy the constitutional requirements the Due Process Clause of the Fourteenth Amendment mandates before the state may deprive an individual of his or her property interest. Although there may be other areas for reform, the Due Process Clause requires, at the least, a well-reasoned written opinion that includes findings of fact and conclusions of law.

I. The SEC-SRO Relationship

In order to determine whether state action is present in securities arbitration, one must first understand the relationship the state has with the private entity alleged to be a state actor. Understanding the relationship between the alleged state actor and the private parties who claim that the state actor has deprived them of their rights is critical because state action is more likely to be found the more intertwined or entangled the alleged state actor is with the state. This section will show that the SEC and the SROs are intertwined in a way that, when considered together with the SEC's requirement that representatives (i.e. brokers) register with SROs, renders the mandatory SRO arbitration process state action.

In the securities industry, all employment disputes are resolved in arbitration sponsored by a SRO¹⁶ such as the New York Stock Exchange (NYSE) or the National Association of Securities Dealers (NASD).¹⁷ Until 1998, SROs required arbitration for all employment disputes between broker-dealers and registered representatives. A 1998 NASD rule change exempted statutory discrimination claims from compulsory

16. 15 U.S.C. § 780-3(b) (1994).

17. SROs include the major national securities exchanges and the NASD. *See* Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(26) (1994). In addition, SROs require arbitration of customer-broker disputes if the customer demands it. NASD, *Manual of Procedural Rules* § 10301 (2001); NYSE, Inc., *Rules & Constitution* § 600(a) (2003). Although the SROs do not mandate arbitration, all brokerage firms require that customers sign a pre-dispute agreement to arbitrate in order to open an account with the brokerage.

arbitration.¹⁸ Shortly after this rule change, the NYSE and numerous other exchanges adopted the NASD rule.¹⁹ Although discrimination claims have been exempted from arbitration, the existence of a variety of non-discrimination employment disputes as well as the prospect that the securities industry could reverse its decision on discrimination claims ensures that the question of whether state action is present in securities arbitration is still quite relevant.²⁰

Although SROs are not federal agencies, they are responsible for protecting investors from wrongful acts their members commit.²¹ No statute mandated the creation of these SROs and the government does not appoint SRO board members. In addition, government employees do not serve on any NASD or NYSE board or committee. Nevertheless, the SROs maintain significant government connections. For example, the Securities Exchange Commission (SEC) is responsible for providing

18. NYSE, Inc., Const. art. XI, § 1 (2003) (“[a]ny controversy between parties who are members, allied members or member organizations and any controversy between a member, allied member or member organization and any other person arising out of the business of such member, allied member or member organization . . . shall at the instance of any such party, be submitted for arbitration in accordance with the provisions of this Constitution and such rules as the Board may from time to time adopt.”); NYSE, Inc., Rules and Constitution § 600(a) (2003) (any customer or non-member dispute with a member shall be arbitrated pursuant to written agreement or customer or non-member demand); *Id.* § 607 (all non-members and public customers with disputes involving over \$10,000 will have claims arbitrated by three-person panel); Order Granting Approval to Proposed Rule Change Relating to the Arbitration of Employment Discrimination Claims, Exchange Act Release No. 40,109, 67 SEC Docket 824, 1998 WL 327716 (June 22, 1998) (associated persons are no longer required to arbitrate statutory employment discrimination claims but must still arbitrate other employment-related claims and business-related claims involving customers or other persons).

19. *See, e.g.*, NYSE, Inc., Rules and Constitution § 600(f) (June 2003) (“[a]ny claim alleging employment discrimination, including any sexual harassment claim, in violation of a statute shall be eligible for submission to arbitration under these Rules only where the parties have agreed to arbitrate the claim after it has arisen.”).

20. When the NASD announced the rule change, it stated that “associated persons still will be required to arbitrate other employment-related claims” Order Granting Approval to Proposed Rule Change Relating to the Arbitration of Employment Discrimination Claims, Exchange Act Release No. 40,109, 1998 WL 327716 at *1. Non-discrimination employment claims include, but are not limited to, the following: Family and Medical Leave Act, ERISA, whistleblower, Employee Polygraph Protection Act, invasion to privacy, disclosure of trade secrets or confidential information, Fair Credit Reporting Act, defamation, wrongful termination, negligent supervision, and intentional infliction of emotional distress.

21. Federal law requires the NASD to promulgate rules that balance the need to “protect investors and the public interest [and prohibit] unfair discrimination between customers, issuers, brokers, or dealers.” 15 U.S.C. § 78o-3(b)(6) (2003).

oversight of the SROs.²² The SEC must approve each SRO's organizational rules before the rules become effective.²³ The SEC also reviews existing SRO rules and may approve or disapprove proposed new rules.²⁴ Moreover, it can alter or abrogate existing rules²⁵ and may proceed against a SRO if the SRO does not enforce its own rules. The SEC also ensures quality and competence of representatives through registration requirements and criminal conviction reporting requirements.²⁶

More importantly, the SEC has been anything but a passive bystander regarding the implementation of SRO arbitration. In 1975, Congress amended the Exchange Act and "drastically shifted the balance of rulemaking power in favor of Commission oversight."²⁷ According to a Senate Report, the 1975 amendments conferred upon the SEC "a much larger role than it had in the past . . ." over the SROs.²⁸ The 1975 amendments, among other things, dramatically curtailed the SROs' freedom to regulate without SEC control.²⁹ Following adoption of the amendments, the SROs had to submit a proposed rule, with accompanying supporting material, to the SEC for approval. The SEC would then submit the rule for public comment and ultimately make a decision whether or not to approve the rule. The SEC could approve the proposed rule only if the rule is consistent with the requirements and goals of the Exchange Act "to protect investors and the public interest."³⁰

The amendments also impacted SRO arbitration procedures. In the late 1970s, the SEC began pushing for a systematic method for resolving small securities claims. In response to this push, SRO representatives,

22. 15 U.S.C. § 78s (2003).

23. 15 U.S.C. § 78f(a)-(b), 78o-3(a)-(b) (2003). One commentator stated that the SEC's ability to approve or disapprove SRO rules enables the SEC to "virtually exercise[] plenary authority over the arbitration [p]rocedures adopted by the national securities exchanges and securities self-regulatory associations." THOMAS H. OEHMKE, 1 COMMERCIAL ARBITRATION § 28:8 (2004).

24. § 78s(1).

25. *Id.*; see also *Shearson/Am. Express, Inc. v. McMahon*, 482 U.S. 220, 232 (1987) (stating that the SEC has plenary authority over SRO arbitration procedures and has the power to "abrogate, add to, and delete from" SRO arbitration rules if necessary or appropriate to enforce the Securities Act).

26. 17 C.F.R. § 240.15b7-1 (1993); 17 C.F.R. § 240.15b2-2 (1993).

27. See *Credit Suisse First Boston Corp. v. Grunwald*, 400 F.3d 1119, 1129 (9th Cir. 2003).

28. *Id.* at 1130.

29. *Id.*

30. 15 U.S.C. § 78o-3(b)(6) (2003).

the public and the Securities Industry Association formed the Securities Industry Conference on Arbitration (SICA). SICA created a Uniform Code of Arbitration that the SROs adopted in 1979-80.³¹ Although the SROs are not obligated to follow SICA's recommendations, until very recently, they have done so.³² In addition, following adoption of the 1975 amendments, the SEC created the U-4 registration form which includes the standard clause mandating arbitration of all disputes arising out of a registered representative's employment.³³

In 1986, the Supreme Court, in *Shearson/American Express v. McMahon*,³⁴ ruled that federal securities claims could be arbitrated. In that case, the Court emphasized that the SEC had "expansive power to ensure the adequacy of the arbitration procedures employed by the SROs."³⁵ According to the Court, the SEC's ability to change, delete or abrogate SRO rules if it believes they are inconsistent with the objectives of the Exchange Act gives the SEC plenary power over SRO arbitration procedures.³⁶

Following the *McMahon* decision, the SEC sent a letter to SICA recommending substantial reforms of the existing informal arbitration process. The SEC recommended that arbitrators should be trained in securities and relevant state law, that a record of the proceedings be maintained to facilitate judicial review of arbitration awards, and that the awards themselves become somewhat more detailed.³⁷ While the SROs did not adopt all of the SEC's recommendations, they nevertheless significantly reformed the arbitration process.³⁸ The SEC approved these

31. Barbara Black & Jill I. Gross, *Making It Up as They Go Along: The Role of Law in Securities Arbitration*, 23 CARDOZO L. REV. 991, 998 (2002).

32. *Id.*

33. *Intercontinental Indus., Inc. v. Am. Stock Exch.*, 452 F.2d 935, 941, n.9 (5th Cir. 1971).

34. 482 U.S. 220, 232 (1987).

35. *Id.* at 233. The Court noted that the SEC has not always had plenary authority regarding the rules governing the SROs. According to the Court, however, the 1975 Amendments to § 19 of the Exchange Act conferred substantial power on the SEC to ensure the adequacy of arbitration procedures. Among other things, the Court stated, proposed rules may not be enacted unless the SEC approves them. In addition, the SEC may, independently, change or delete any SRO rules if it finds such action necessary to "further the objectives of the Act." *Id.*

36. *Id.* at 233-34.

37. Letter from Richard G. Ketchum, Director of Division of Market Regulation, SEC, to SICA Members, in MARK D. FITTERMAN, ET AL., SEC INITIATIVES FOR CHANGES IN SRO ARBITRATION RULES 257, 279 App. A (1988).

38. *Id.*

reforms,³⁹ but did not abandon its previous efforts and indicated that it would continue to push for arbitration reform particularly if arbitration became an exclusive forum for resolution of securities disputes.⁴⁰ The SEC has continued to monitor the use of arbitration and recommend changes to the arbitration process throughout the 1980s and 1990s.⁴¹ According to Professors Black and Gross, “the SEC and SROs have spent considerable time and effort since *McMahon* to amend procedural rules governing securities arbitrations”⁴²

Moreover, in a series of recent cases, the SEC itself has emphasized that its oversight of the SROs is “comprehensive” and that only the SEC can decide what kinds of rules and standards are appropriate for governance of SRO arbitration procedures.⁴³ In *Credit Suisse First Boston Corp. v. Grunwald* and *Jevne v. Superior Court*, both the Ninth Circuit and the California Supreme Court concluded that the NASD arbitration rules have the “force of federal law” and thus pre-empt California’s arbitrator ethics regulations.⁴⁴ In the *Jevne* case, the SEC stated that “only the Commission can decide what disclosure and disqualification standards are appropriate for the protection of investors and employees in SRO arbitration”⁴⁵ Although both the SEC and

39. See Order Approving Proposed Rule Changes by the NYSE, NASD, and AMEX Relating to the Arbitration Process and the Use of Predispute Arbitration Clauses, Exchange Act Release No. 26,805, 43 SEC Docket 1250, 1989 SEC LEXIS 843 (May 10, 1989).

40. *Id.*

41. See, e.g., Adoption of Form U-3, Now Designated Form BD, and Amendment of Rule 15b3-1; Adoption of Form U-4 and Amendment of Rule 15b8-1, Exchange Act Release No. 11,424, 7 SEC Docket 2 (May 16, 1975) (form U-4); Order Approving Proposed Rule Changes by the NYSE, NASD, and AMEX Relating to the Arbitration Process and the Use of Predispute Arbitration Clauses, Exchange Act Release No. 26,805, 1989 SEC LEXIS 843 at *5 (during the past two decades, “[t]he majority of the proposals to amend the [exchange] arbitration rules were . . . in response to the . . . Commission letters.”); *id.* at *3-*5, *7, *16, *22, *31, *32, *44 n.51, *51 n.59 (describing the SEC’s ongoing series of letters to SICA, that presented the SEC recommendations regarding the exchanges’ arbitration procedures, and requested that the exchanges amend their rules to conform to the SEC’s views, and resulted in a series of proposed rule changes that were developed in response to the Commission’s letters. Approving multiple changes to arbitration procedures, including fee, discovery, and panel selection matters, and rejecting public comments requesting, *inter alia*, that arbitrators be required to state the reasons for their decisions).

42. Black & Gross, *supra* note 31, at 1005.

43. See *Credit Suisse First Boston Corp. v. Grunwald*, 400 F.3d 1119 (9th Cir. 2003); see also *Jevne v. Superior Ct.*, 111 P.3d 954 (Cal. 2005).

44. *Credit Suisse First Boston Corp.*, 400 F.3d at 1121; *Jevne*, 111 P.3d at 972.

45. *Jevne*, 111 P.3d at 969.

the SROs assert that SROs are not state actors, the SEC's actions speak considerably louder than their words.

Perhaps the most critical piece of support for a finding of state action in securities arbitration was the SEC's decision in 1993 to implement a requirement that all representatives register with an SRO.⁴⁶ As the Ninth Circuit stated in *Duffield v. Robertson Stephens & Co.*, the new rule is a "government-mandated 'condition to any participation in a . . . securities career.'"⁴⁷ For registered representatives beginning employment since 1993, the SEC is effectively mandating participation in arbitration for disputes that arise during the course of employment. While the agreement to arbitrate is contained in a private contract with an SRO, the mandatory registration requirement, when considered together with the lack of dispute resolution alternatives available to registered representatives, transforms the SRO mandatory arbitration process into state action.

Scrutinizing the relationship between the SEC and the SROs reveals that the SEC has been actively involved in creating and amending the SRO arbitration process. The SEC is empowered to ensure that SRO arbitration procedures adequately protect individual's due process rights and is consistently involved in ensuring that, in its view, these rights are vindicated appropriately in the SRO arbitration process. Moreover, fully aware that SROs require arbitration of employment and other types of claims, the SEC mandated that representatives register with an SRO as a condition of their employment. The SEC's energetic participation in the formation and maintenance of the SRO arbitration process, together with its registration requirement, demonstrates that the relationship between the entities is very closely intertwined and transforms the private SRO into a state actor when it requires that brokers participate in the arbitration process.⁴⁸

46. See 17 C.F.R. § 240.15b7-1 (1993).

47. 144 F.3d 1182, 1201 (9th Cir. 1998) (quoting *Blount v. SEC*, 61 F.3d 938, 941 (D.C. Cir. 1995)).

48. Professor Stephen J. Ware contended that the close relationship between SROs and the SEC created state action when the SRO mandated arbitration because such pervasive governmental regulation invalidates employee consent to the arbitration process. Stephen J. Ware, *Employment Arbitration and Voluntary Consent*, 25 HOFSTRA L. REV. 83, 138-59 (1996). Others have contended that SROs are state actors in other contexts, such as when they conduct criminal investigations of persons who have allegedly committed securities offenses. See William I. Friedman, *The Fourteenth Amendment's Public/Private Distinction Among Securities Regulators in the U.S. Marketplace—Revisited*, 23 ANN. REV. BANKING & FIN. L. 727 (2004); Jody Freeman, *The Private Role in Public Governance*, 75 N.Y.U. L. REV. 543, 579 (2000).

II. State Action Doctrine

In this article, I contend that SROs are state actors when they mandate that their employees resolve disputes using arbitration. SROs are state actors in this context because the SEC, a government agency, requires that brokerage employees register with an SRO as a condition of their employment. The registration requirement, when considered with the SRO requirement that employees arbitrate their claims, creates state action. To understand why an SRO is a state actor in the arbitration context, this article will examine the state action jurisprudence, both in the Supreme Court and lower courts, to determine what case law is relevant to evaluate the question of whether state action is present in securities arbitration. Once the relevant principles for assessing state action are identified, the article will apply those legal principles to the arbitration context.

A. Theory Underlying State Action

The Supreme Court's state action doctrine explains that constitutional protections of individual rights and liberties apply only to the actions of governmental bodies. Unless the person or entity charged with a constitutional violation is acting on behalf of the state, no constitutional action against that person or entity can be maintained. The state action doctrine is important because it assures the maintenance of the public/private dichotomy that lies at the very heart of liberal democratic theory.⁴⁹ In order to maintain the dichotomy, the state action doctrine dictates that courts must carefully consider the implications of extending to non-governmental actors constitutional norms designed to limit governmental power. Proper consideration is essential to ensure that the boundaries between judicial and legislative authority are maintained,⁵⁰ that constitutional norms are not extended so far that they

49. JOHN LOCKE, SECOND TREATISE OF GOVERNMENT 44-73 (Thomas P. Reardon ed., Bobbs-Merrill 1952) (1690); Erwin Chemerinsky, *Rethinking State Action*, 80 NW. U. L. REV. 503, 535-36 (1985) [hereinafter Chemerinsky, *Rethinking*]; Sheila S. Kennedy, *When is Private Public? State Action in the Era of Privatization and Public-Private Partnerships*, 11 GEO. MASON U. CIV. RTS. L.J. 203, 209 (2001); Paul Schiff Berman, *Cyberspace and the State Action Debate: The Cultural Value of Applying Constitutional Norms to "Private" Regulations*, 71 U. COLO. L. REV. 1263, 1288-89 (2000); G. S. Buchanan, *A Conceptual History of the State Action Doctrine: The Search for Government Responsibility*, 34 HOUS. L. REV. 333, 336 (1997).

50. See *Lugar v. Edmondson Oil Co.*, 457 U.S. 922, 936-37 (1982) (court enforcement of state action transfers authority from legislative to judicial branch

become liberty-infringing rather than liberty-enhancing,⁵¹ and that federal governmental authority remains properly circumscribed.⁵² At the same time, a state action doctrine is necessary so that private actors, acting on behalf of the state, do not infringe on or violate the rights of others.

While the theory underlying state action is well-understood, determining whether an individual is a state actor when she allegedly violates constitutional rights is not easily predictable. As numerous commentators have stated, predicting when and under what circumstances state action exists is both one of the more difficult and important questions confronting the federal courts today.⁵³ This article will offer a basic outline of the Court's state action doctrine and then apply it to securities arbitration.

The threshold inquiry in any case involving a private individual or entity accused of violating the Fourteenth Amendment is whether that private entity may be regarded as a state actor.⁵⁴ While the Court views the state action inquiry as a "fact-intensive" one, it has nevertheless

rendering regulatory framework subject to judicial modification); *Costa del Moral v. Servicios Legales de Puerto Rico*, 63 F. Supp. 2d 165, 171-72 (D.P.R. 1999); *Parker v. Clarke*, 905 F. Supp. 638, 641-42 (E.D. Mo. 1995); *Total Television Entm't Corp. v. Chestnut Hill Vill. Assocs.*, 145 F.R.D. 375, 378-79 (E.D. Pa. 1992); *Smith v. Wood*, 649 F. Supp. 901, 908 (E.D. Pa. 1986); *In re Johnson*, 460 N.Y.S.2d 932, 956-57 (N.Y. App. Div. 1983) (Niehoff, J., dissenting).

51. For example, procedural due process requirements that ensure governmental action is neither arbitrary nor capricious would greatly disrupt the operation of a private business or dispute resolution system. Chemerinsky, *Rethinking*, *supra* note 49, at 535-36 (state action doctrine protects individual liberty by creating zone of conduct that need not comply with the Constitution).

52. See *Lugar*, 457 U.S. at 936; *Flagg Bros., Inc. v. Brooks*, 436 U.S. 149, 156 (1978); *Jackson v. Metro. Edison Co.*, 419 U.S. 345, 349 (1974); *The Civil Rights Cases*, 109 U.S. 3 (1883); *Cmty. Med. Ctr v. Emergency Med. Servs. of Ne. Penn.*, 712 F.2d 878, 879 (3d Cir. 1983); *Elam v. Montgomery County*, 573 F. Supp. 797, 803 (S.D. Ohio 1983). Chemerinsky, *Rethinking*, *supra* note 49, at 536 (limiting constitutional protections to state action preserves state sovereignty by allowing state to govern private behavior).

53. See Martin A. Schwartz & Erwin Chemerinsky, *Dialogue on State Action*, 16 *TOURO L. REV.* 775, 776 (2000); Ware, *supra* note 48, at 559; Reuben, *supra* note 8, at 990; Ronald J. Krotoszynski, Jr., *Back to the Briarpatch: An Argument in Favor of Constitutional Meta-Analysis in State Action Determinations*, 94 *MICH. L. REV.* 302, 304 (1995) (applying state action test is difficult); Chemerinsky, *Rethinking*, *supra* note 49, at 503; Charles L. Black, Jr., *Foreword: "State Action," Equal Protection, and California's Proposition 13*, 81 *HARV. L. REV.* 69, 95 (1967) (state action is a "conceptual disaster area."); R. George Wright, *State Action and State Responsibility*, 23 *SUFFOLK U. L. REV.* 685 (1989).

54. Krotoszynski, *supra* note 53, at 314.

routinely used four tests to determine whether state action is present in a particular case.⁵⁵ First, state action exists when the government becomes excessively entangled with private behavior and encourages or causes the unconstitutional behavior.⁵⁶ Second, state action exists when a private entity performs what is traditionally an exclusively public function.⁵⁷ Third, state action exists when the private actor and the government have a “symbiotic relationship.”⁵⁸ Finally, the Court may consider whether there is “pervasive entwinement” between the state and private entities.⁵⁹ While these formulations provide broad guidance to courts faced with state action questions, the range of factors that may be relevant in a particular case makes predicting the outcome of a state action case extremely difficult. Because securities arbitration involves a government agency interacting with private entities, the most salient question is whether the government’s involvement in the decisions of the securities industry members when they implement their arbitration program rises to the level of state action. Thus, for purposes of this paper, the primary relevant test is entanglement.⁶⁰ As a result, this article will focus on the

55. *Flagg Bros., Inc.*, 436 U.S. at 166; *Jackson*, 419 U.S. at 357; *Moose Lodge No. 107 v. Irvis*, 407 U.S. 163, 173 (1965); *Adickes v. S. H. Kress & Co.*, 398 U.S. 144, 170 (1970); *Am. Mfrs. Mut. Ins. Co. v. Sullivan*, 526 U.S. 40, 52 (1999); *Reitman v. Mulkey*, 387 U.S. 369, 378 (1967); *Mentavlos v. Anderson*, 249 F.3d 301, 311 (4th Cir. 2001); *DeBauche v. Trani*, 191 F.3d 499, 507 (4th Cir. 1999); *Lansing v. City of Memphis*, 202 F.3d 821, 808 (6th Cir. 2000); *Rendell-Baker v. Kohn*, 457 U.S. 830 (1982) (no close nexus between private school’s personnel decisions and state even though state extensively regulates school); *Blum v. Yaretsky*, 457 U.S. 991 (1982) (state not responsible for nursing home decision to transfer patients even though state extensively regulates nursing homes).

56. See *Sullivan*, 526 U.S. at 52; *Kohn*, 457 U.S. 830 (holding no close nexus between private school’s personnel decisions and state even though state extensively regulates school); *Yaretsky*, 457 U.S. 991 (holding that the state not responsible for nursing home decision to transfer patients even though state extensively regulates nursing homes); *Flagg Bros., Inc.*, 436 U.S. at 166; *Adickes*, 398 U.S. at 170; *Mulkey*, 387 U.S. at 378; *Irvis*, 407 U.S. at 173; *Anderson*, 249 F.3d at 311; *City of Memphis*, 202 F.3d at 808; *Trani*, 191 F.3d at 507.

57. *Flagg Bros., Inc.*, 436 U.S. at 157; *Jackson*, 419 U.S. at 353; *Rendell-Baker*, 457 U.S. at 842; *Edmonson v. Leesville Concrete Co.*, 500 U.S. 614, 621 (1991).

58. *Burton v. Wilmington Parking Auth.*, 365 U.S. 715 (1961) (illustrating symbiotic relationship).

59. *Brentwood Acad. v. Tenn. Secondary Sch. Athletic Ass’n*, 531 U.S. 288 (2001).

60. To establish a symbiotic relationship that turns a private entity into a state actor, courts engage in a “highly contextual” inquiry that focuses on whether the private entity receives state subsidies or aid. See *Burton*, 365 U.S. at 723; A. Michael Froomkin, *Wrong Turn in Cyberspace: Using ICANN to Route Around the APA and the Constitution*, 50 DUKE L. J. 17, 123 (2000) (citing *J.K. v. Dillenberg*, 836 F. Supp. 694, 698 (D. Ariz. 1993)). In *Burton*, the Court emphasized that the correct inquiry involved “sifting facts and weighing circumstances” to determine if there is a symbiotic

Court's use of the entanglement test.

1. Entanglement

To determine whether entanglement exists, a court considers whether there is such a close nexus between the State and the challenged action that the action may be "fairly treated as that of the State itself."⁶¹ Action taken by private entities with the mere approval or acquiescence of the State is not state action.⁶² Instead, entanglement may be found if the challenged activity results from the State's provision of "significant encouragement, either overt or covert."⁶³

Like the state action inquiry generally, the question of whether the nexus is sufficiently close has always been a fact-intensive one.⁶⁴ Nevertheless, certain principles guide Supreme Court jurisprudence. A review of the Supreme Court cases involving state action reveal that the

relationship. 365 U.S. at 722. The Court determined in *Burton* that the public funds provided to the facility, together with state agency ownership and operation, created a symbiotic relationship. *Id.* at 722-26. *Burton* was the high watermark for the symbiotic relationship test. Today, the Court will find symbiotic relationships only in cases involving direct governmental aid to the alleged state actor. See JOHN E. NOWAK, ET AL., CONSTITUTIONAL LAW § 12.4, at 528 (6th ed. 2000). In arbitration, direct government subsidies to the alleged wrongdoer, the arbitral litigant, are nonexistent. Even when the government pays the private third party neutral, which happens only in court-ordered arbitration, application of the symbiotic relationship test would result in a finding that the arbitrator is a state actor, a fact that this article concedes. Because no direct subsidy is provided to the arbitral litigants in court-ordered or contractual arbitration, the symbiotic relationship test is inapposite. The public function test is satisfied when a function that is traditionally an exclusive governmental service is delegated to a private actor. Examples of traditional public functions include running a political primary and managing a town. See *Terry v. Adams*, 345 U.S. 461 (1953); *Marsh v. Alabama*, 326 U.S. 501 (1946). According to the public function doctrine, state action attaches only to those functions that the government traditionally has performed. The Supreme Court has narrowly defined the public function category and has held that dispute settlement is not traditionally an exclusive state function. *Flagg Bros., Inc.*, 436 U.S. at 161. In light of *Flagg Bros., Inc.* and the fact that arbitration has long existed outside of the judicial system, it seems very unlikely that securities arbitration would be considered a public function. For additional discussion of this issue, see Cole, *supra* note 13.

61. *Brentwood*, 531 U.S. at 289 (2001) (citing *Jackson v. Metro. Edison Co.*, 419 U.S. 347, 351 (1974)); *Flagg Bros., Inc.*, 436 U.S. at 157; see *Adickes*, 398 U.S. at 170.

62. *Blum v. Yaretsky*, 457 U.S. 991, 1004-05 (1982); *Jackson*, 419 U.S. at 357.

63. *Blum*, 457 U.S. at 1004 (citations omitted).

64. *Lugar v. Edmondson Oil Co.*, 457 U.S. 922, 939 (1982) (state action determination is a "necessarily fact-bound inquiry"); *Burton*, 365 U.S. at 726 (a state action finding "can be determined only in the framework of the peculiar facts or circumstances present."); *Brentwood Acad.*, 531 U.S. at 295-96; see also *Jackson*, 419 U.S. at 349-50; *Moose Lodge No. 107 v. Irvis*, 407 U.S. 163, 172 (1965).

Court divides state action cases into two categories: [1] cases that involve direct or indirect racial decision-making; and [2] cases that do not involve race-based classifications. Because the decision to send cases to arbitration in the securities industry is made without regard to race,⁶⁵ only the second category of cases is relevant to determining whether state action is present in securities arbitration. For entanglement cases that do not involve race, commentators examining the Supreme Court cases have concluded that the Court engages in a contacts analysis to determine whether state action is present.⁶⁶ In other words, to determine entanglement, the Court evaluates the interactions between the state entity and the private entity alleged to have engaged in state action to determine whether there are sufficient contacts between the two to satisfy the state action requirement.

a. Non-Race-Based Entanglement Cases

To determine whether state action is present, courts focus on the number and quality of contacts that exist between the government and the private action.⁶⁷ Contacts giving rise to a finding of entanglement include significant government encouragement, funding, licensing, and/or regulation.⁶⁸ Although there is no identifiable point when the numerosity of contacts becomes excessive entanglement, at some point along the “nexus continuum” the courts will find that a private actor’s behavior, because of its connectedness with the state, is state action.⁶⁹

65. The strongest argument for application of the more lenient race-based entanglement test is that the SEC’s encouragement of arbitration to resolve disputes in the securities industry has a disproportionate impact on minorities. Yet, in the context of judicial decisions to enforce private actions that disadvantage racial minorities, the Court has repeatedly held that state action does not arise unless there is some non-neutral involvement of the courts with the private action. *See Bell v. Maryland*, 378 U.S. 226 (1964); *Evans v. Abney*, 396 U.S. 435 (1970). In the securities context, the Court would consider whether the SROs’ collective decision to send all cases to arbitration is a neutral scheme. Since there is no evidence that the SRO selectively chooses which cases to send to arbitration, even if arbitration has a disproportionate impact on minorities (a fact certainly not in evidence), the Court would not apply the race-based entanglement test to evaluate whether the SRO action is state action.

66. NOWAK ET AL., *supra* note 60, at 519 (no formal test for amount of contacts that rises to the level of state action); *See Krotzysynski*, *supra* note 53, at 337 (meta-analysis including number of contacts); *see also Buchanan*, *supra* note 49.

67. Buchanan, *supra* note 49, at 347 (court examines one or more links or contact points); Krotzysynski, *supra* note 53, at 314-15 (contacts analysis).

68. NOWAK, ET AL., *supra* note 60, § 12.3, at 519-27, and § 12.4, at 528-40.

69. Buchanan, *supra* note 49, at 347; Krotzysynski, *supra* note 53 (advocating contacts analysis).

The Supreme Court's state action cases most analogous to the SEC-SRO relationship are those that involve pervasive state regulation of the private entity.⁷⁰ It is rare for the Supreme Court to find entanglement in these cases. Nevertheless, a case law examination helps to articulate the process a court would use to evaluate whether state action is present in a particular case. The factual scenarios most similar to the SEC-SRO relationship occur in *Jackson v. Metropolitan Edison Co.* and *American Manufacturers Mutual Insurance Co. v. Sullivan*.⁷¹

In *Jackson*, a customer claimed her due process rights were violated when the electric utility terminated her services without notice and a hearing.⁷² The Court held that no state action was present even though the state licensed the utility and the company had a virtual monopoly on provision of electrical services. The Court emphasized that the utility which took the action was the subject of the customer's complaint was privately held and operated, rather than publicly owned. Moreover, the Court noted, the utility's termination of services practices, while part of a provision of a general tariff filed with the Public Utility Commission (PUC), were never subject to Commission scrutiny. Because the state actor, the PUC, never specifically authorized or approved the utility's termination practices, even the heavy state regulation combined with the state's virtual monopoly on utility services did not meet the threshold for

70. An examination of all the Supreme Court cases applying the entanglement test would be unhelpful since there are no state action cases directly on point and the cases involve fact intensive analysis. I have selected two prominent state action cases where the private entity is extensively regulated by the state—a factual situation that is similar to that presented by the relationship between the SEC and the brokerage members. The analogy may be helpful to shed light on the kinds of factors the Court considers salient when conducting state action analysis. Lower courts have addressed more analogous cases. In *Alliance for Community Media v. FCC*, 10 F.3d 812 (D.C. Cir. 1993), for example, the D.C. Circuit found state action when Congress implemented regulations that conferred authority on cable television operators to ban indecent material from cable access channels but stripped them of editorial control over any other type of programming. According to the court, these regulations were intended to further a government policy designed to limit children's access to indecent material. The regulations furthered the government policy by defining what constituted indecent material and then requiring operators to identify indecent material on access channels. The government also expressed a willingness to step in to resolve disputes over the definition of indecent material. *Id.* at 819. Rejecting the government's argument that the cable operator ultimately makes the decision whether to permit access to indecent programming, the court held that the statutory scheme "significantly encourages" the cable operators to comply with the government policy and thus is state action. *Id.* at 818.

71. *Jackson v. Metro Edison Co.*, 419 U.S. 347 (1974); *Am. Mfrs. Mut. Ins. Co. v. Sullivan*, 526 U.S. 40 (1999).

72. *Jackson*, 419 U.S. at 347.

state action. Although the Court suggested that the outcome might have been different had the government been more actively involved in approving the challenged process, the lack of overt state encouragement of the termination practice “does not transmute a practice initiated by the utility . . . into state action.”⁷³

In *American Manufacturers Mutual Insurance Co. v. Sullivan*,⁷⁴ the Court examined Pennsylvania’s workers’ compensation scheme. Under this scheme, an employer found liable for an employee’s work-related injury is responsible for all “reasonable and necessary” medical expenses.⁷⁵ In 1993, Pennsylvania created a utilization review organization (URO) to review contested workers’ compensation claims. Under the 1993 legislation, insurers were authorized to withhold payment of workers’ compensation benefits to employees after the insurer filed a claim with the URO asserting that the payments were not reasonable and necessary.⁷⁶ The claimants in *Sullivan*, ten employees and two employee organizations who received benefits under the act, sued defendants, two Pennsylvania program administrators and private insurance companies that offered workers’ compensation coverage.⁷⁷ The claimants contended that the state’s creation of a system designed to permit withholding of payments was state action, which denied them due process without proper notice or hearing.⁷⁸

The Court stated that claimants must show both that a constitutional deprivation of a state-created right or privilege had occurred and that the “party charged with the deprivation must be a person who may fairly be said to be a state actor.”⁷⁹ Acknowledging that the 1993 amendments may encourage insurers to withhold payments for disputed medical

73. *Id.* at 357. The Court rejected the customer’s attempt to analogize her case to the situation in *Public Utilities Commission of District of Columbia v. Pollak*, 343 U.S. 451 (1952). In that case, the District of Columbia PUC investigated the transit company’s use of piped music on public buses. *Pollak*, 343 U.S. at 451. After conducting a full hearing, the Commission concluded that the transit company’s practices were “not inconsistent with public convenience, comfort and safety,” and, moreover, that such practices might improve conditions for those riding the bus. *Id.* at 463-65. The *Jackson* Court rejected the plaintiff’s attempt to analogize her situation to *Pollak* because “no such imprimatur” was placed on the private utility’s termination practices because no approval process occurred. *Jackson*, 419 U.S. at 357. In the absence of such approval, the challenged termination practice could not be considered state action. *Id.* at 357-59.

74. 526 U.S. 40 (1999).

75. *Id.* at 44.

76. *Id.* at 45-47.

77. *Id.* at 47-48.

78. *Id.* at 48.

79. *Id.* at 50 (internal quotations and citations omitted).

treatment, the Court concluded that the second requirement was not satisfied by a demonstration that the state encouraged the behavior.⁸⁰ According to the Court:

subtle encouragement is no more significant than that which inheres in the State's creation or modification of any legal remedy. We have never held that the mere availability of a remedy for wrongful conduct, even when the private use of that remedy serves important public interests, so significantly encourages the private activity as to make the State responsible for it.⁸¹

In other words, a scheme that enables or even encourages withholding of payment will not create state action when the decision whether to withhold payment is made by the private insurer acting alone.⁸²

The Court also considered whether a private party's use of a state-created dispute resolution system imbued the private action with state action characteristics.⁸³ Although the URO's decisions, like any other state-created adjudicative entity, would be considered state action, the Court concluded that a private party's mere use of the State's dispute resolution machinery, without the "overt, significant assistance of state officials," cannot.⁸⁴ Thus, even when the state creates both the mechanism and the procedures through which a deprivation may occur and, by so doing, encourages parties to use it, the Court will not find state action.⁸⁵

Sullivan, like *Jackson*, involves a heavily regulated industry—worker's compensation insurance.⁸⁶ In *Sullivan*, the state created a dispute resolution system that private parties might decide to utilize.⁸⁷ Yet the Court found that there is no state action in the creation of this system because the insurance companies are neither obligated nor even overtly encouraged to use the system.⁸⁸ *Jackson* suggests that state action is not present when a governmentally regulated industry makes private decisions that affect another's rights. *Sullivan* adds that even if

80. *Sullivan*, 526 U.S. at 50.

81. *Id.* at 53; *Tulsa Prof'l Collection Servs, Inc. v. Pope*, 485 U.S. 478, 485 (1988) ("Private use of state-sanctioned private remedies or procedures does not rise to the level of state action."); *see also* *Lugar v. Edmondson Oil Co.*, 457 U.S. 922, 937 (1982); *Flagg Bros., Inc. v. Brooks*, 436 U.S. 149, 165-66 (1978).

82. *See Sullivan*, 526 U.S. at 53.

83. *Id.* at 54.

84. *Id.* (citing *Tulsa*, 485 U.S. at 486).

85. *Id.* at 57.

86. *Id.* at 56.

87. *Id.* at 45.

88. *Id.* at 52-54.

the industry makes use of a state structure to deprive the person of her rights, state action is still not present. Applying this analysis to the SEC-SRO relationship suggests that state action may be present in that context. The SEC heavily regulates the SROs.⁸⁹ While the SROs create their own dispute resolution practice (akin to the *Jackson* termination practice), the SEC, unlike the government in *Jackson*, is actively involved in managing the way in which the dispute resolution services are delivered. Moreover, the SEC mandates that individuals register with an SRO.⁹⁰ In *Jackson*, by contrast, the use of utility services is, at most, implicitly required due to the utility's virtual monopoly on utility services. In addition, unlike *Sullivan*, the SEC does strongly encourage the use of SRO arbitration procedures.⁹¹ Not only does the SRO approve, modify and reject SRO arbitration rules, but it also mandates that representatives register with the SROs.⁹² This mandatory registration requirement changes the dynamics of the relationship—while insurers in *Sullivan* may or may not use the state-created dispute resolution system—the securities broker-dealers and representatives have no alternative to using the SRO-created and SEC-approved arbitration procedures. Thus, it may be that applying *Jackson* and *Sullivan* to securities arbitration would result in a finding of state action.

b. Lower Court Cases

While the Supreme Court has not directly addressed the question of whether state action is present in securities arbitration, several lower courts have considered whether securities arbitration involves state action.⁹³ While the claimants in these cases were unsuccessful,

89. See, e.g., Order Granting Approval to Proposed Rule Change Relating to the Arbitration of Employment Discrimination Claims, Exchange Act Release No. 40,109, 67 SEC Docket 824 (June 22, 1998); OEHMKE, *supra* note 23; Shearson/Am. Express, Inc. v. McMahon, 482 U.S. 220, 232 (1987).

90. See Order Granting Approval to Proposed Rule Change Relating to the Arbitration of Employment Discrimination Claims, Exchange Act Release No. 40,109, 67 S.E.C. Docket 824.

91. *Id.*

92. McMahon, 482 U.S. at 232.

93. See, e.g., Perpetual Secs., Inc. v. Tang, 290 F.3d 132, 137-39 (2d Cir. 2002); Koveleskie v. SBC Capital Markets, Inc., 167 F.3d 361, 368-69 (7th Cir. 1999); Desiderio v. Nat'l Ass'n of Secs. Dealers, Inc., 191 F.3d 198, 206-07 (2d Cir. 1999); Lodal v. Home Ins. Co. of Ill., No. 95-2187, 1998 WL 393766, at *6 (6th Cir. 1998); Duffield v. Robertson Stephens & Co., 144 F.3d 1182 (9th Cir. 1998); Century Aluminum of W. Va. v. United Steelworkers of Am., 82 F. Supp. 2d 580, 583 n.4 (S.D. W. Va. 2000); Cremin v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 957 F. Supp. 1460

examination of two of these cases reveals that their analysis is actually supportive of a state action finding because they were decided prior to the SEC's institution of a registration requirement for brokers.⁹⁴ The cases intimate that results would have been different had the claimants been hired after 1993 when the registration requirement went into effect.⁹⁵ This section will examine decisions in which state action has been found in relationships similar to that between the SEC and the SROs. These decisions indicate that there is strong precedent for finding that SROs are state actors as long as the SEC requires brokers and others to register with an SRO as a condition of their employment.

So intertwined are the SEC and the SROs, that even before the institution of the 1993 registration requirement, at least two plaintiffs alleged that the close relationship between the SEC and the SROs means that SROs are state actors⁹⁶ when they compel employees to participate in arbitration.⁹⁷ To establish that the SRO is a state actor, member employees relied principally on the excessive entanglement argument.⁹⁸ The member employee claimed an SRO becomes excessively entangled

(N.D. Ill. 1997).

94. *Duffield*, 144 F.3d at 1182; *Cremin*, 957 F. Supp. at 1460.

95. *Id.*

96. When analyzing whether an entity is a state actor, a court considers whether the action that the plaintiff challenges is state action. *Jackson v. Metro. Edison Co.*, 419 U.S. 345, 351 (1974) ("[T]he inquiry must be whether there is a sufficiently close nexus between the State and the challenged action of the regulated entity so that the action of the latter may be fairly treated as that of the State itself."). In other words, a court does not determine whether an entity is a state actor for purposes of every decision it makes. Instead, the court considers only whether the entity was a state actor when it made the decision that adversely affected the plaintiff. *Nat'l Collegiate Athletic Ass'n v. Tarkanian*, 488 U.S. 179, 192 (1988) ("[I]n the typical case raising a state-action issue, a private party has taken the decisive step that caused the harm to the plaintiff, and the question is whether the State was sufficiently involved to treat that decisive conduct as state action.").

97. *Perpetual Secs., Inc. v. Tang*, 290 F.3d 132 (2d Cir. 2002); *Desiderio v. Nat'l Ass'n of Secs. Dealers, Inc.*, 191 F.3d 198 (2d Cir. 1999); *Duffield v. Robertson Stephens & Co.*, 144 F.3d 1182 (9th Cir. 1998), *overruled on other grounds by* *EEOC v. Luce, Forward, Hamilton & Scripps*, 345 F.3d 742, 745 (9th Cir. 2003). Every court has rejected the contention that securities arbitration is state action. However, no court has analyzed the state action question since the SEC enacted its 1993 amendments that require brokers to register with an SRO.

98. The Ninth Circuit in *Duffield* appeared to consider the public function argument as well. Comparing the SEC's role in regulating the SROs to the role of the Public Utilities Commission in *Jackson v. Metropolitan Edison Co.*, 419 U.S. 345 (1974), the court concluded that the SEC "has been no more aggressive than the Public Utilities Commission in *Jackson*." *Duffield*, 144 F.3d at 1202. Thus, as in *Jackson*, no state action should be found.

with the government when the SEC moves from simply approving an SRO's decision to require members to arbitrate to encouraging or endorsing that action.⁹⁹ According to the claimants, the encouragement came from the SEC's ability to approve, reject, or abrogate existing SRO rules.¹⁰⁰ Courts rejected this argument, holding instead that the SEC is not excessively entangled with the SROs because nothing in the Securities Acts or in the Commission rules or regulations *requires* arbitration as a means to resolve disputes within the SROs and the SEC does not compel SROs to utilize arbitration as a means to resolve disputes.¹⁰¹

In attempting to convince the court that the SRO is engaged in state action, the litigants argued that because the SEC compelled them to register with an SRO as a condition of their employment, the SEC was sufficiently entangled with the SRO to create state action.¹⁰² Both the Ninth Circuit in *Duffield v. Robertson Stephens & Co.* and the Northern District of Illinois in *Cremin v. Merrill Lynch, Pierce, Fenner & Smith, Inc.* rejected this argument because, prior to 1993, no federal statute or regulation *required* a member to register with the securities exchanges or arbitrate disputes with the member's employer.¹⁰³ In 1993, however, the SEC adopted a regulation that required all broker-dealers to register with at least one SRO.¹⁰⁴ Although the *Duffield* court characterized the new rule as federal law, it nevertheless rejected *Duffield's* argument that because the SEC compelled her to remain registered after the 1993 rule change, state action was present.¹⁰⁵ According to the court, that she was compelled to remain registered was "immaterial."¹⁰⁶ The court went on to say:

No federal law required *Duffield* to waive her right to litigate employment-related disputes by signing the Form U-4 [arbitration agreement] in 1988, and no state action is present in simply enforcing that agreement. Insofar as *Duffield* argues that the 'challenged action' is the requirement that she

99. *Duffield*, 144 F.3d at 1202.

100. *Id.* at 1201.

101. *Id.* at 1202.

102. *Id.* at 1201; *Cremin v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 957 F. Supp. 1460 (N.D. Ill. 1997).

103. *Duffield*, 144 F.3d at 1201; *Cremin*, 957 F. Supp. at 1466.

104. See 17 C.F.R. § 240.15b7-1 (adopted May 11, 1993).

105. *Duffield*, 144 F.3d at 1201. The court called the rule a "government-mandated 'condition to any participation in a . . . securities career.'" *Id.* (quoting *Blount v. SEC*, 61 F.3d 938, 941 (D.C. Cir. 1995)).

106. *Id.*

actually arbitrate her lawsuit, that requirement is found in her private contract, not in federal law.¹⁰⁷

The Northern District of Illinois rejected Cremin's claim on virtually identical grounds.¹⁰⁸

While it is true that the arbitration requirement is in the SRO's U-4 agreement, one might argue that if the SEC, with knowledge of the arbitration obligation, requires a broker-dealer to register with an SRO or compels the broker-dealer to remain registered with the SRO, it is directing the broker-dealer to arbitrate his or her dispute. While the pre-1993 SRO rule requiring arbitration did not satisfy the state action requirement, the post-1993 requirement that broker-dealers register with one of the SROs may indicate that the arbitration requirement is state action.¹⁰⁹

While such a conclusion is not automatic, analysis of related cases suggests it is the right answer. As the *Duffield* court made clear, the requirement that broker-dealers register with an SRO is quintessential government regulation. The next question is whether this government-mandated condition of registration with an SRO, when that SRO mandates that the registrant resolve all disputes using arbitration, is sufficient overt or covert encouragement of arbitration to support a finding that the SROs are state actors when they require arbitration.

Considering the same issue in the context of municipal securities, the D.C. Circuit found in *Blount v. SEC* that a rule regulating the conduct of brokers that was promulgated by the Municipal Securities Rulemaking Board (MSRB) and approved by the SEC was state action.¹¹⁰ The court

107. *Id.*

108. *Cremin*, 957 F. Supp. at 1466 (examining law at the time Cremin registered, 1982, not the post-1993 law).

109. The *Duffield* court suggested this conclusion: In 1993, however, the Securities and Exchange Commission (SEC) adopted a regulation that required all broker-dealers to be registered with at least one of the securities organizations of which *Duffield's* firm was a member (i.e. the NASD and the NYSE) before effecting any securities transaction. See 17 C.F.R. § 240.15b7-1 (adopted May 11, 1993). That registration regulation, like the SEC's registration regulation at issue in *Blount v. SEC*, 61 F.3d 938 (D.C. Cir. 1995), "operates not as a private compact among brokers and dealers but as federal law." *Id.* at 941. Hence, to borrow *Blount's* reasoning, as a government-mandated "condition to any participation in a . . . securities career," the current requirement that new employees register with a national securities exchange "constitutes government action of the purest sort." *Duffield*, 144 F.3d at 1201 (While the *Duffield* court did not conclude that the SRO-imposed arbitration agreement constituted state action, the holding that the registration requirement is state action suggests that consequences that flow directly from the requirement would also constitute state action.).

110. *Blount v. SEC*, 61 F.3d 938, 941 (D.C. Cir. 1995). Rule G-37, at issue in

found that the MSRB was a state actor when it enforced its conduct rule because the Exchange Act requires brokers and dealers to register with the MSRB before they may trade municipal securities and violations of MSRB rules may result in sanctions including suspension or loss of the broker-dealer's trading license.¹¹¹ The court concluded that Rule G-37 was government action because it was a "government-enforced condition to any participation in a municipal securities career."¹¹² Under *Blount's* reasoning, a registration requirement together with regulatory enforcement of a private entity's rules satisfies the requirement for state action.

The primary difference between the MSRB and other SROs like the NASD is that the government created the MSRB but not the other SROs. Yet the *Blount* court put this distinction aside when it assessed whether the implementation of Rule G-37 was state action.¹¹³ If this distinction is irrelevant,¹¹⁴ it is difficult to see a difference between the SEC's relationship with the SROs and their arbitration requirement and the MSRB's decision to promulgate a regulation that effects the purpose of the Exchange Act. After all, the SEC regulates SROs closely and federal regulations mandate that broker-dealers from each SRO register with the SEC.¹¹⁵ In fact, the considerable interaction and close relationship that exists between the SEC and the non-municipal SROs suggests an even stronger argument in favor of state action than in the *Blount* case.

The SEC's active involvement in regulating arbitration, together with the reasoning in the leading case, *Blount*, suggests that SROs are

Blount, restricted municipal securities professionals from engaging in "pay to play". In other words, the rule prohibited brokers from making contributions to or soliciting contributions on behalf of state officials from whom they obtain business.

111. *Id.* at 941.

112. *Id.*

113. *Id.* The court said, "[w]e put to one side the Board's questionable assertion that it is a purely private organization even though it was created by an act of Congress and directed by Congress to 'propose and adopt rules to effect the purposes of the [Exchange Act]' within specified constraints." *Id.*

114. The distinction may be irrelevant both because the *Blount* court did not consider it in analyzing the state action question and because it makes little difference as a practical matter. Although Congress mandated the creation of the MSRB, it is an SRO that is organized as a nonprofit corporation governed by Virginia law. A private entity does not become public simply because federal legislation creates it. ROBERT A. FIPPINGER, *THE SECURITIES LAW OF PUBLIC FINANCE* § 9:7.4, at 9-103 (2001). Fippinger concluded that "the congressional mandate of the creation of the MSRB, as opposed to its creation as a voluntary association of brokers, dealers, and municipal securities dealers, has little relevance to whether the MSRB is private or public and governmental." *Id.*

115. 17 C.F.R. § 240.1567-1 (1993).

state actors when they require broker-dealers to arbitrate disputes following the SEC's 1993 adoption of a mandatory registration requirement.¹¹⁶ Like the brokers in *Blount*, securities arbitration of non-discrimination employment disputes is a government-enforced condition to participation in a securities career. Thus, the arbitration requirement "constitutes government action of the purest sort."¹¹⁷

Further support for the conclusion that the SROs are state actors following the 1993 amendments can be found in *R.J. O'Brien & Associates, Inc. v. Pipkin*.¹¹⁸ In that case, Pipkin claimed that the National Futures Association (NFA) denied him his constitutional right to due process when it required him to arbitrate claims made against him.¹¹⁹ The Commodity Exchange Act, like the Securities Exchange Act since 1993, requires persons who actively participate in the industry to register under the Act.¹²⁰ The Commodity Futures Trading Commission (CFTC) oversees the regulation of commodities trading and is also empowered to register persons under the Act.¹²¹ The CFTC, as permitted by statute, delegated the registration function to the NFA, a private corporation.¹²²

To support his motion to vacate the arbitration award entered against him, Pipkin contended that the NFA is a state actor when it registers persons.¹²³ The Seventh Circuit agreed, holding that the NFA "certainly is [a state actor] when it requires an applicant to agree to submit to the arbitration rules in order to register under the Act."¹²⁴ Thus, a federal agency delegation of the required registration function to

116. Few courts have considered whether SROs are private or public entities when they enforce their rules. In *Crimmins v. American Stock Exchange, Inc.*, 346 F. Supp. 1256 (S.D.N.Y. 1972), a federal district court concluded that the American Stock Exchange acted as an arm of the federal government when it conducted a disciplinary hearing. While the court found that the SRO was a state actor, it nevertheless concluded that the hearing provided to the broker-dealer satisfied the requirements of the Fifth Amendment. By contrast, the Seventh Circuit, in *Bernstein v. Lind-Waldock & Co.*, 738 F.2d 179, 186 (7th Cir. 1984), held that the Chicago Mercantile Exchange was not a federal actor when it auctioned off a seat. The court emphasized that the private nature of the suit as "only remotely related to the exchange's enforcement functions" in reaching its conclusion that the exchange was not acting as an arm of the federal government. *Id.*

117. *Blount*, 61 F.3d at 941.

118. 64 F.3d 257 (7th Cir. 1995).

119. *Id.* at 259.

120. *Id.*; see also 7 U.S.C. §§ 6f(a), 6k(1) (2000).

121. *Pipkin*, 64 F.3d at 259; see 7 U.S.C. §§ 21(o) (2000).

122. *Pipkin*, 64 F.3d at 259.

123. *Id.* at 262.

124. *Id.*

a private corporation, under *Pipkin*, transforms the private corporation into a state actor. That the private corporation creates its own arbitration procedures and rules does not alter the conclusion. Instead, the court ruled, those procedures and regulations are imposed on the registrant as a precondition to registration under the Act.¹²⁵ Because the registration function is required, agreement to the procedures is also required and the registering entity becomes a state actor.

Applying *Pipkin* to the present situation, the conclusion that an SRO like the NASD is a state actor because the SEC now requires registration with an SRO as a precondition to working in the securities industry seems fairly obvious.¹²⁶ Although each SRO creates its own arbitration procedures and rules, a registrant must agree to them implicitly when it, as required by federal law, registers with an SRO.

III. Peremptory Strikes and the Equal Protection Clause

The Equal Protection Clause prohibits a state actor from excluding a person from serving on a jury on the basis of her race or sex.¹²⁷ Exclusion of the prospective juror occurs through the use of a peremptory strike during the juror selection process. This prohibition, which E. Gary Spitko and I have described elsewhere as the *Batson* principle,¹²⁸ may be extended to the arbitration process if a state actor mandates participation in the process. Extension of the *Batson* principle to the arbitration process would render unconstitutional a party's use of his peremptory strike right to exclude an arbitrator from a panel due to her race or sex.

As we suggested in a previous article, the problem of discriminatory use of peremptory strikes is likely more common than it appears.¹²⁹

125. *Id.*

126. The *Cremin* court was not persuaded by the plaintiff's analogy to *Pipkin*. *Cremin*, 957 F. Supp. at 1466. According to the court, the analogy was inapt because *Cremin* signed the arbitration agreement prior to 1993. *Id.* While the court left open the possibility that *Cremin's* argument would be successful if she had registered after 1993, when she would have been required to do so, it rejected her claim because, prior to 1993, the SEC, unlike the CFTC, did not require individuals to register with an SRO. *Id.* This decision is wrong for the same reason *Duffield* is incorrect—even if *Cremin* registered prior to 1993, post-1993, she had no choice but to remain registered. Thus, her obligation to arbitrate post-1993 is the product of state action.

127. *Batson v. Kentucky*, 476 U.S. 79 (1986).

128. Sarah Rudolph Cole & E. Gary Spitko, *Arbitration and the Batson Principle*, 38 GA. L. REV. 1145, 1147 (2004).

129. *Id.*

Because both the NYSE and NASD provide parties with one peremptory challenge of an arbitrator,¹³⁰ it probably occurs in securities arbitration as well. The primary way in which this problem would arise in securities arbitration is as follows: A party might use his peremptory challenge to create an arbitral panel that disadvantages the other party. For example, if a securities broker was a young, African-American woman, the brokerage against which she had a claim might strike any African-Americans from the panel. In the alternative, the brokerage might strike all the women from a particular panel. Since there are few women or African-Americans on securities arbitration panels (the typical securities arbitrator is still an older white male), efforts to exclude these arbitrators would likely be successful and, at the same time, occur unnoticed.¹³¹

In the trial context, the Supreme Court has ruled that the Equal Protection Clause prohibits a state actor from excluding a person from serving on a jury on the basis of his race or sex.¹³² In another article, Professor E. Gary Spitko and I explored whether it is permissible for a party to a court-ordered or contractual arbitration to exercise a peremptory strike against a potential arbitrator on the basis of the potential arbitrator's race, sex or other characteristic that would not be a permissible basis for such a strike of a potential juror in a public court proceeding.¹³³ We concluded that state action is not present when a private litigant exercises a peremptory challenge in a contractual arbitration proceeding but is present when the litigant exercises the challenge in a court-ordered arbitration.¹³⁴ With respect to contractual arbitration, we concluded that a court would determine that the factors present in cases where state action is found—overt racial discrimination,

130. NYSE, Inc., Rules & Constitution § 609 (2003) (stating that a party has one peremptory challenge that must be used within ten days of notification of arbitrator names); NASD, Manual of Procedural Rules §10311 (2001) (explaining that a party has one peremptory challenge that must be exercised within ten days after notification). Both forums allow an additional peremptory challenge in the "interests of justice." See NASD, Code of Arbitration Procedure § 10311; NYSE, Inc., Rules & Constitutions § 609.

131. Another example of discriminatory selection of an arbitrator occurred in *Smith v. American Arbitration Ass'n, Inc.*, 233 F.3d 502, 504 (7th Cir. 2000), when a party opposing a female litigant struck the sole female arbitrator from the list of fifteen potential arbitrators provided to the parties by AAA. Ruling against the female litigant, the court stated that no state action is present when arbitrator selection occurs pursuant to a private contract between private parties who are under no obligation to arbitrate their disputes. *Id.*

132. *Batson*, 476 U.S. at 98-99; *J.E.B. v. Alabama ex rel. T.B.*, 511 U.S. 127, 129 (1994).

133. Cole & Spitko, *supra* note 128, at 1147.

134. *Id.* at 1195-96.

compulsion of jurors in a public setting or institutional integrity of the court system—are not present when a litigant exercises a peremptory challenge in the arbitral setting.¹³⁵ In the absence of a state action finding, discriminatory peremptory challenges are not unconstitutional.¹³⁶

This article, by contrast, focuses on the question of whether state action is present when the SEC requires representatives to register with an SRO as a condition of their employment when the SRO subsequently mandates that they participate in arbitration. Unlike contractual arbitration, strong arguments support the notion that the SEC's encouragement of the arbitration process for securities employment disputes together with the registration requirement creates state action in securities arbitration. If one is convinced by the arguments presented in Parts I and II, then a party's decision to strike a prospective arbitrator on a discriminatory basis would violate the other party's right to equal protection. Applying the *Batson* principle to securities arbitration, a party who suspects that an arbitrator was removed because of her race or sex should be able to bring a claim in court challenging any subsequently issued arbitration award on the ground that the arbitrator selection process was discriminatory.¹³⁷

IV. Securities Arbitration: Employment Claim as Property Right

Reform of securities arbitration will not automatically occur following a finding that the SEC's mandatory registration requirement is state action. Once a court finds state action in securities arbitration, the next inquiry is whether an employee's claim is a property right.¹³⁸ This

135. *Id.* at 1240.

136. *Id.* at 1163.

137. In *Arbitration and the Batson Principle*, Professor Spitko and I proposed a process for challenging an arbitration award due to discriminatory selection or exclusion of an arbitrator. *Supra* note 128. If a disputant has reason to believe that an arbitrator was selected or excluded for discriminatory reasons, the disputant must notify the opposing disputant within seven days of discovering that discrimination occurred. The disputant must then seek a hearing with the arbitrator or arbitral panel within fourteen days of discovering that discrimination occurred during the selection of the arbitrator or arbitral panel. During the hearing, the arbitrator or arbitral panel will hear evidence under oath from all parties involved in the alleged discriminatory selection or exclusion. If the arbitrator or arbitral panel finds discrimination in the selection or exclusion of an arbitrator, then the arbitrator or arbitral panel shall order the removal or replacement of any arbitrator affected by the discriminatory selection. A party may bring a claim in court under the proposed section for up to thirty days after the final arbitration award is entered. *Id.* at 1227-28.

138. The Due Process Clause also protects liberty interests. Under current Supreme

question is essential to reforming securities arbitration because the Due Process Clause can be invoked only to protect liberty or property interests. This section of the article will consider whether the SEC's mandate that employees with employment-related claims proceed in arbitration deprives the employee of a property interest in the forum established by state or federal law. If the right to proceed in a particular forum is a property right, then the next consideration is how much process is due before the state can deprive the individual of that interest.

The Due Process Clause states that, "[n]o person shall . . . be deprived of life, liberty, or property, without due process of law."¹³⁹ A court will apply the Due Process Clause to state action only if it finds

Court jurisprudence, however, it is extremely unlikely that the reduced process available to an employee in securities arbitration amounts to deprivation of a liberty interest. The employee would contend that she has been deprived of the right to have a particular state or federal agency and, subsequently, a federal court, adjudicate her claim and determine whether she is entitled to damages such as back pay, attorney's fees and other compensatory damages. Moreover, she could argue that she has been deprived of the right not to be deprived of a property interest by her employer. In addition, she could argue that she has been deprived of the ability to have an agency determine whether to clear her record for purposes of obtaining future employment and/or vindicate her in front of her co-workers and peers, thus restoring her dignity and self-esteem by determining whether the employer terminated her for unlawful reasons. Further, she could assert that she was arguably denied her right to have her claim heard by a federal court, following assessment by a state or federal agency. This denial has the effect of preventing her from correcting the impression among co-workers, peers and future employers that she was terminated for non-discriminatory reasons. Finally, diversion to arbitration, the claimant might argue, prevents her from receiving the investigation and hearing the state or federal agency would provide. Denial of this valuable benefit works a hardship on the claimant by preventing her from obtaining an agency finding of reasonable cause. Such a finding, though rare, is a tremendous bargaining chip in subsequent settlement negotiations with the employer. Yet claimant's argument that she is entitled to the protection of the Due Process Clause under a liberty interest theory may be flawed. While she has a property right in her employment claim, it is less clear that she has suffered government defamation in a typical termination case. While termination of one's employment is likely to hinder one's future employability, it is difficult to argue that an employee-at-will's loss of a single job amounts to the kind of defamation at issue in *Owen v. City of Independence*, 445 U.S. 622, 635 (1980) (harm to individual's reputation, together with termination, amounts to deprivation of liberty interest), or *Paul v. Davis*, 424 U.S. 693 (1976) (publication of name on list of shoplifters not a denial of liberty interest). In those cases, the defamation had a much more public character. In addition, in *Owen*, the defamation occurred *at the same time* as the deprivation of the property right. 445 U.S. at 624-30. Moreover, it is hard to argue that termination of an employee-at-will amounts to defamation since the employer rarely provides reasons supporting the termination. In addition, acceptance of the argument that an employee has a liberty interest in the combination of alleged defamation and deprivation of a property right is the kind of slippery slope courts hope to avoid.

139. U.S. CONST. amend. V.

that the state's action has jeopardized a property interest.¹⁴⁰ If a court concludes that the state has deprived an individual of a property interest, the right to some kind of hearing becomes paramount.¹⁴¹ The Constitution does not create property interests; instead, such interests are created and defined by "existing rules or understandings that stem from an independent source such as state law—rules or understandings that secure certain benefits and that support claims of entitlements to those benefits."¹⁴² Once a state creates a property right, it may not deprive an individual of that right "except pursuant to constitutionally adequate procedures."¹⁴³

To successfully challenge securities arbitration procedures for procedural due process violations, a securities employee must establish that she has a property right in her employment claim. If the employee has a property right, then she would need to demonstrate that the state's diversion of her claim to arbitration results in a deprivation of that right without adequate procedural safeguards. The Supreme Court addressed the question of whether a cause of action is a property right in *Logan v. Zimmerman Brush Co.*¹⁴⁴ In *Logan*, the plaintiff filed a charge with the Illinois Fair Employment Practices Commission, claiming that Zimmerman Brush had unlawfully discriminated against him on the basis of his handicap when it terminated his employment.¹⁴⁵ Pursuant to the Illinois Fair Employment Practices Act, the Commission was required to hold a hearing within 120 days after a claimant filed a charge.¹⁴⁶ The Commission failed to hold the hearing within the designated time period.¹⁴⁷ Concluding that the time period was mandatory, the state court dismissed Logan's claim.¹⁴⁸ Logan appealed, contending that the Commission's failure to hold a hearing within the allotted time violated his right to due process because the FEP Act created a property interest

140. RICHARD J. PIERCE, JR., SIDNEY A. SHAPIRO & PAUL R. VERKUIL, *ADMINISTRATIVE LAW AND PROCESS* 229 (3d ed. 1999). The article focuses on property rights because the argument that an employee's legal claim is a liberty interest is fairly weak.

141. *Bd. of Regents of State Colls. v. Roth*, 408 U.S. 564 (1972).

142. *Id.* at 577.

143. *Cleveland Bd. of Educ. v. Loudermill*, 470 U.S. 532, 541 (1985).

144. 455 U.S. 422 (1982).

145. *Id.* at 426.

146. *Id.*

147. *Id.*

148. *Id.* at 426-27.

in a discrimination cause of action.¹⁴⁹ The Supreme Court agreed, holding that a state created cause of action is "a species of property protected by the Fourteenth Amendment's Due Process Clause."¹⁵⁰ Moreover, the right was constitutionally protected because Illinois had guaranteed to Logan a right to redress "under what is, in essence, a 'for cause' standard."¹⁵¹ Subsequent cases confirm the theory that an individual has a property right in a cause of action under a state-created statutory scheme.¹⁵²

Although the Court did not specify the procedures the Commission should use, it outlined the requirements of due process.¹⁵³ According to the Court, the Commission should "consider the merits of [the] claim, based upon the substantiality of the available evidence, before deciding whether to terminate his claim"¹⁵⁴ Thus, under *Logan*, a court may not constitutionally authorize the deprivation of a state-conferred property interest without following applicable procedural safeguards. Moreover, the federal Constitution is the standard against which the adequacy of the state-offered procedural safeguards must be measured.¹⁵⁵

The next question is whether the alternative scheme provided by the state (or state actor) satisfies constitutional due process requirements.¹⁵⁶ Once a claimant establishes that he has a property right, he looks to federal law to determine what procedures he is entitled to under the Due Process Clause before the government may deprive him of that right. While the securities firms, as state actors, may have articulated procedures to govern their disposition of an employee's property right, whether those procedures satisfy the Due Process Clause is a question of

149. *Id.* at 430.

150. *Id.* at 428 (citing *Mullane v. Cent. Hanover Bank & Trust Co.*, 339 U.S. 306, 313 (1950)).

151. *Id.* at 431. The Court also noted that the "hallmark of property" is "an individual entitlement grounded in state law which cannot be removed except 'for cause.'" *Id.* at 430. In other words, once the state grants an entitlement to an individual, such as the ability to pursue an employment discrimination claim through a state agency process, the state may not take away that right without demonstrating good reason. The existence of the state scheme is what creates the necessary "for cause" requirement.

152. *Cooper v. Bombala*, 34 F. Supp. 2d 693, 698 (N.D. Ill. 1999); *Jabbari v. Ill. Human Rts. Comm'n*, 527 N.E.2d 480, 483 (Ill. App. Ct. 1988); *Salazar v. Ohio Civil Rts Comm'n*, 528 N.E.2d 1303, 1307 (Ohio Ct. App. 1987) (right to file handicap discrimination charge is property right); *Bennett v. Tucker*, 827 F.2d 63, 70 (7th Cir. 1987) (claimant's right to have department determine claim is a property right).

153. *Logan*, 455 U.S. at 433-34.

154. *Id.* at 434.

155. *Id.* at 432.

156. See *Salazar*, 528 N.E.2d at 1307.

federal law. To determine what process is due in securities arbitration, a court would look to the test the Supreme Court articulated in *Mathews v. Eldridge*,¹⁵⁷ a seminal case on the question of how much due process is constitutionally sufficient. In *Mathews*, the Court set forth a three-part balancing test to be used in deciding what process is due before the state deprives an individual of a property interest.¹⁵⁸ The Court's flexible and context-specific test identifies three factors to be considered:

[F]irst, the private interest that will be affected by the official action; second, the risk of an erroneous deprivation of such interest through the procedures used, and the probable value, if any, of additional or substitute procedural safeguards; and finally, the Government's interest, including the function involved and the fiscal and administrative burdens that the additional or substitute procedural requirement would entail.¹⁵⁹

In evaluating the second factor, regarding the reliability of the challenged procedures and the possible value of extra process, the Court created a balancing test where due process is determined through a weighing of the costs and benefits of whatever procedures the claimant contends the due process clause requires.¹⁶⁰ Following *Mathews*, the Court has repeatedly demonstrated that the balancing test is the critical factor in determining whether additional process is due.¹⁶¹

For example, in *Logan*, the Court applied this test to determine how much process an employee is entitled to before the government could deprive him of his employment discrimination claim.¹⁶² In *Logan*, the Court said that the private interests at stake included the right to be free from employment discrimination and to a procedure that allowed vindication of that right.¹⁶³ The risk of erroneous deprivation of the right was high, at least in *Logan's* case, where the state agency reached no determination regarding the merits of *Logan's* claim and provided no procedural safeguards to prevent or reduce the impact of the error when the termination was due to the agency's negligence.¹⁶⁴ Weighed against these two factors, the Court considered the state's administrative

157. 424 U.S. 319 (1976).

158. *Id.* at 334-35.

159. *Id.* at 335.

160. *Van Harken v. City of Chicago*, 103 F.3d 1346, 1351 (7th Cir. 1997) (citations omitted).

161. *Logan v. Zimmerman Brush Co.*, 455 U.S. 422, 434 (1982).

162. *Id.* at 433-35.

163. *Id.* at 434.

164. *Id.* at 434-35.

interests. While administrative costs undoubtedly weigh against too many procedural safeguards, the Court concluded that the additional cost of avoiding terminating someone's claim in its entirety could hardly be said to outweigh the other relevant considerations.¹⁶⁵ That few claimants will be in Logan's position further supported the Court's conclusion. Thus, in *Logan*, application of the *Mathews* test led to the conclusion that the existing procedures did not satisfy due process.¹⁶⁶ While the Court did not articulate the procedure the FEPC should follow, it emphasized that the State must "consider the merits of his charge, based upon the substantiality of the availability of evidence, before deciding whether to terminate his claim."¹⁶⁷ In other words, before Logan's claim can be terminated, he is entitled to some kind of hearing to adjudicate his state-created tort claim.

Because *Mathews* demands an individualized cost-benefit analysis in each case where a claimant demands additional due process, it is difficult to predict when and under what circumstances a court will find that the Due Process Clause is or is not satisfied. Applying *Mathews* to securities arbitration, however, yields clearer results than is typical in a procedural due process case, at least with respect to the use of written, reasoned opinions. Because the costs of opinions are now documented¹⁶⁸ and the various interests relatively easy to quantify, the *Mathews* test applied to securities arbitration reveals that the Due Process Clause requires the use of well-reasoned written opinions in securities arbitration.

V. Well-Reasoned Written Opinion Requirement

According to NASD rules, arbitration awards must be in writing and include "a summary of the issues . . . the damages (awarded) . . . and a statement of any other issues resolved."¹⁶⁹ The rules do not require the arbitrators to write opinions with reasons supporting their conclusions.¹⁷⁰ Not surprisingly, few NASD arbitration awards contain anything other than a statement of the issues and an indication of whether or not relief

165. *Id.* at 437 n.10.

166. *Id.* at 434-35.

167. *Id.* at 434.

168. *See infra* pp. 106-08.

169. NASD, Code of Arbitration Procedure § 10330(e).

170. Marilyn Blumberg Cane & Marc J. Greenspon, *Securities Arbitration: Bankrupt, Bothered and Bewildered*, 7 STAN. J.L. BUS. & FIN. 131, 146 (2002).

was granted.¹⁷¹ Applying *Mathews* against this backdrop demonstrates that well-reasoned opinions are required in securities arbitration.

Under *Mathews*, a court must consider both the private interest in additional procedures and the government interest the challenged policy advances. The private interests at stake in securities arbitration, as in *Logan*, are the right to be free from illegal on-the-job mistreatment and to a procedure that allows an employee to vindicate that right. Next, a court would consider whether the existing procedures used to evaluate the interest are likely to result in an erroneous deprivation of that interest. Unquestionably, plaintiffs believe well-reasoned opinions are necessary to ensure proper handling of their claims. While some contend that creating a well-reasoned opinion requirement would undermine the efficiency of the arbitration process,¹⁷² the voices clamoring for explanations of adverse decisions continue to demand this change to the arbitration process.¹⁷³ However, an individual is not entitled to process simply because he wants it. Instead, he must demonstrate that without the additional procedural safeguards, an erroneous deprivation of his property right may occur. Without reasoned written opinions, the risk of discriminatory and illegitimate awards is considerable. In the absence of a means for holding arbitrators accountable for their decisions, there is a risk that arbitrators will make decisions for arbitrary and capricious

171. See, e.g., *Podber v. Interstate Johnson Lane/Wachovia, Inc.*, 2003 WL 271323 (NASD Jan. 23, 2003); *Bell v. Morgan Stanley Dean Witter*, 2002 WL 535953 (NASD Mar. 1, 2002); *Walborn v. Aetna Life Ins. & Annuity Co.*, 2001 WL 1004226 (NASD Aug. 1, 2001). Professor Jennifer J. Johnson reviewed NASD opinions from 2003-04 resolving customer-broker disputes. She found that in 2003, only 5% of the 2077 customer cases closed through arbitration offered even a brief explanation of the panel's decision. In 2004, her review of arbitration awards revealed that fewer than 5% of the 2,423 NASD customer cases closed through the arbitration process included an opinion that explained the award. See Jennifer J. Johnson, *Wall Street Meets the Wild West: Bringing Law and Order to Securities Arbitration*, 84 N.C. L. REV. __ (2006).

172. Barbara Black, *The Irony of Securities Arbitration Today: Why Do Brokerage Firms Need Judicial Protection?*, 72 U. CIN. L. REV. 415, 450-51 (2003).

173. See Cane & Greenspon, *supra* note 170, at 151-52 ("[S]ecurities arbitrators should be compelled to provide written rationale for their award. While this may lessen arbitral finality, it may preserve the fundamental principles of fairness upon which any dispute resolution system operates."). DAVID E. ROBBINS, SECURITIES ARBITRATION PROCEDURE MANUAL 13-14 (5th ed. 2001). A GAO report concluded that most industry representatives and investors (this was a survey of consumers and brokers) support federal legislation requiring arbitrators to write a short opinion when issuing an arbitration award. U.S. GEN. ACCOUNTING OFFICE, SECURITIES ARBITRATION: HOW INVESTORS FAIR 53-54 (1992), available at <http://archive.gao.gov/d32t10/146692.pdf>. Jean Sternlight states that due process requires that the parties "know at least something of the arbitrator's rationale." Sternlight, *supra* note 8, at 95.

reasons or for reasons that are inconsistent with well-established law. Thus, the well-reasoned opinion requirement may be necessary to avoid erroneous deprivation of the plaintiff's property right.

One proponent of written arbitration awards, Stephen Hayford, contends that the absence of reasoned awards in the commercial arbitration context is particularly troubling because without it, parties have no "reliable indicia of whether the arbitrator's decision was founded on a full understanding of the material facts and a proper interpretation and application . . . of the relevant law."¹⁷⁴ Moreover, Hayford argues, the failure to provide parties with any insight regarding the arbitrator's decision making process encourages losing parties to be dissatisfied with the arbitration process, and, more problematically, to attempt to vacate the arbitration award.¹⁷⁵ Professor Black contends, by contrast, that written opinions will not be beneficial and that the vacatur challenges occur for other reasons.¹⁷⁶ If Hayford's claims are true, however, the absence of reasoned written opinions may be reducing the efficiency of securities arbitration, a result that the government would neither desire nor intend. Thus, the private interest in reasoned written opinions is strong *and* the government's interest (the third *Mathews* factor) may actually be served by the addition of a reasoned written opinion as a procedural safeguard.

The government's interest, including the potential of increased fiscal and administrative burdens, is minimal here for three reasons. First, the addition of the well-reasoned written opinion requirement might improve the efficiency of the arbitration process because requests for vacatur might be reduced. Second, the increased costs are minimal. According to the NASD, the increased cost of requiring arbitrators to provide reasons for their decisions adds only \$300 to the cost of the arbitration in a consumer case.¹⁷⁷ One would expect that the costs would change minimally in a case involving an employee. Finally, the state would experience no increased administrative burden. The arbitrators who heard the case would simply spend two or three additional hours discussing the case, deliberating and then writing down the reasons for their decision. Other than a slight increase in the costs associated with

174. Stephen L. Hayford, *A New Paradigm for Commercial Arbitration: Rethinking the Relationship Between Reasoned Awards and the Judicial Standards for Vacatur*, 66 GEO. WASH. L. REV. 443, 446 (1998).

175. *Id.*

176. See Black, *supra* note 172, at 451.

177. See *infra* p. 110.

paying the arbitrator,¹⁷⁸ no additional administrative burden is detectable. Thus, the government interest in preventing this additional procedural safeguard is minimal.

Of course, the inquiry does not end with an examination of the individual's and state's interests. *Mathews* also requires a court to consider whether additional procedural protections increase the likelihood that the government's decision is correct.¹⁷⁹ Applying this factor, lower courts find that an individual is entitled to additional due process only if the benefits of the additional procedure outweigh the costs of that procedure.¹⁸⁰ To understand the benefits of a written opinion, the article turns to the field of cognitive psychology.

Cognitive psychologists analyze the methods individuals use to make decisions and offer suggestions about how to improve decision quality.¹⁸¹ Cognitive psychologists believe that individuals utilize heuristics to assist them when evaluating available choices. These heuristics are short cuts that individuals use to make the decision making

178. The NASD's proposal permits customers or associated persons to request an "explained decision." NASD, NASD Proposed Rule Change, SR-NASD-2005-032, available at http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_013542 (last visited Jan. 6, 2005). An explained decision is a "fact-based award stating the reason(s) each alleged cause of action was granted or denied. Inclusion of legal authorities and damage calculations is not required." NASD, Rule § 10330(j)(2) (Proposed Change 2005). In developing this proposed rule, the NASD may have incorrectly assessed the costs of their explained decision requirements. Moreover, it may be that the Due Process Clause demands greater explanation of decisions than does the proposed NASD rule. In addition, the demands placed on the arbitrators by the proposed rule change may require a change in the way arbitrators are trained and paid. Though often experienced in dispute resolution or securities (and sometimes both), NASD arbitrators are essentially volunteers who receive little training and insignificant remuneration. If the NASD's rule change is approved, or if the Due Process Clause demands greater explanation in awards, both arbitrators' compensation and training would likely need to be enhanced. Obviously, these increases would affect the financial burden of reasoned opinions for the government. See Barbara Black, *Do We Expect Too Much from NASD Arbitrators? It's Time for Serious Consideration of Professional Arbitrators*, 2004 SEC. ARB. COMMENTATOR 1 (2004).

179. PIERCE, SHAPIRO & VERKUIL, *supra* note 140, at 274-75.

180. *Van Harken v. City of Chicago*, 103 F.3d 1346, 1351 (7th Cir. 1997) "the use of cost-benefit analysis to determine due process is not to every constitutional scholar's or judge's taste, but it is the analysis . . . followed by the lower courts . . ." *Id.* (citing *United States v. James Daniel Good Real Prop.*, 510 U.S. 43, 53 (1993)); *Zinemon v. Burch*, 494 U.S. 113, 127 (1990); *McCollum v. Miller*, 695 F.2d 1044, 1048 (7th Cir. 1982); *Sutton v. City of Milwaukee*, 672 F.2d 644 (7th Cir. 1982); *Chem. Waste Mgmt., Inc. v. EPA*, 873 F.2d 1477, 1483 (D.C. Cir. 1989); *Artway v. Attorney General of New Jersey*, 81 F.3d 1235, 1251 (3d Cir. 1996)).

181. Mark Seidenfeld, *Cognitive Loafing, Social Conformity, and Judicial Review of Agency Rulemaking*, 87 CORNELL L. REV. 486, 491-92 (2002).

process less cognitively demanding.¹⁸² An individual's use of various heuristics to make certain kinds of decisions will, most of the time, result in sufficiently accurate decisions. Yet, cognitive psychologists have discovered that individuals use these short cuts even when their use results in inaccurate decision making. For example, the availability heuristic describes the situation where an individual correlates his ability to recall a type of event with the likelihood that the event will occur. In other words, if one can recall an event easily, one is likely to believe that the event will reoccur more often than is statistically supportable. Thus, the availability heuristic leads a decision maker to over-predict the likelihood of events that are easy for him to recall.¹⁸³

Together with availability, numerous other heuristics help individuals make quick and relatively accurate decisions every day about where to eat dinner and what route to take to work. Yet, the use of these heuristics to make more complex decisions may lead to poor results. Fortunately, recent research in the field has identified yet additional heuristics that individuals use to reduce the decisional error resulting from interaction among the various biases. These might be called "modifying heuristics." That is, they are heuristics that operate on top of other heuristics to correct the bias that results from use of those initial heuristics. Research on one of these modifying heuristics, known as accountability, suggests that the more likely an individual is to be held accountable for his decisions, the more likely he will make efforts to improve the quality of his decision making.¹⁸⁴ In other words, the greater a decision maker's responsibility for a judgment, the more careful and complete will be his use of the relevant evidence.¹⁸⁵ Accountability also reduces the extent to which decision makers are subject to some of the

182. *Id.* at 494-95.

183. Mark Seidenfeld offers an example of the impact of the availability heuristic in the context of EPA rulemaking. According to Seidenfeld, legal scholars believe that "virtually every rule promulgated by the EPA is challenged in court." The statistics reveal that only 3 to 26% of EPA rules are challenged. This difference between "folklore and reality," states Seidenfeld, "may well reflect that rules subject to challenge are much more salient in the minds of members of the agency and hence easier for them to recall, leading agency members to believe that eighty percent or more of all rules were challenged." *Id.* at 501-02.

184. David M. Sanbonmatsu, Sharon A. Akimoto & Earlene Biggs, *Overestimating Causality: Attributional Effects of Confirmatory Processing*, 65 J. PERS. & SOC. PSYCHOL. 892, 896 (1993); see also Philip E. Tetlock, Linda Skitka & Richard Boettger, *Social and Cognitive Strategies for Coping with Accountability: Conformity, Complexity, and Bolstering*, 57 J. PERS. & SOC. PSYCHOL. 632 (1989).

185. Sanbonmatsu, *supra* note 184, at 896.

various other types of psychological biases described above.¹⁸⁶ In addition, accountability causes a decision maker to be more careful with his decision if he may suffer negative consequences because he failed to justify the decision by providing a satisfactory explanation for it.¹⁸⁷ Although accountability may have other effects on a decision maker, cognitive psychologists agree that one effect of accountability is to increase the likelihood that a decision maker will consider all relevant evidence and “modify initial impressions in response to contradictory evidence.”¹⁸⁸

In the securities arbitration context, the accountability heuristic suggests that an arbitrator who is obligated to provide parties with a reasoned written opinion will be more careful in evaluating the evidence and less likely to be influenced by inherent decision making biases. This will result in three effects. First, the arbitrator will be aware that the parties will be likely to view him negatively (i.e. hold him accountable) if the reasons the arbitrator provides for his decision are unsatisfactory. Thus, accountability will lead arbitrators to be more careful when providing justifications for their decisions. Second, a written opinion makes judicial review more likely, and also makes it more likely that judicial review will be meaningful. Thus, the possibility of judicial review is a further accountability check that will limit an arbitrator’s tendency to rely inappropriately on biases rather than analysis.¹⁸⁹

While cognitive psychology cannot quantify the benefit of making a decision maker accountable, it does suggest that more accurate decisions and meaningful judicial review are a likely outcome of increasing

186. These other biases often lead a decision maker to inferior decisions. The bias heuristics include attribution (the tendency to attribute one’s beliefs and opinions to others), overconfidence (experts tend to be overconfident about decisions they make based on relevant evidence) and availability (the ability to recall similar events to assist in the current decision). Decision makers can be affected by other biases as well. Mark Seidenfeld, *The Psychology of Accountability and Political Review of Agency Rules*, 51 DUKE L. J. 1059, 1063-64 (2001).

187. *Id.* at 1064.

188. Tetlock, *supra* note 184, at 632.

189. Professor Mark Seidenfeld examined the accountability heuristic in the context of arbitrary and capricious judicial review of administrative agency rule-making. According to Seidenfeld, judicial review creates agency accountability. This accountability reduces the decision maker’s reliance on shortcuts which often represent use of inappropriate biases. Arbitrary and capricious review reduces the impact of individual biases in agency decision making and creates the proper incentives for agency staff “to take appropriate care and to avoid many systematic biases when formulating rules and ushering them through the rulemaking process.” Seidenfeld, *supra* note 186, at 547-48.

decision maker accountability. The next question, then, is to what extent the benefits of accountability are outweighed, if at all, by the increased cost of written opinions. Fortunately, unlike most cases analyzed under the *Mathews* rubric, good empirical evidence exists regarding the costs of adding the reasoned written opinion procedure. Recently, the NASD proposed an amendment to its rules that would require arbitrators to provide written awards at the request of consumers' counsel.¹⁹⁰ According to the NASD, the additional cost of a written explanation is \$600.¹⁹¹ NASD offered in its amendment to pay for half of the costs.¹⁹² NASD predicts that the request will be made in 300 to 500 of the approximately 1500 *consumer* arbitrations NASD administers each year.¹⁹³ While this amendment, if adopted, will assist consumers, it does not appear to change the nature of awards in the employment context, which this article addresses. Nevertheless, the quantification of opinion costs provides employees with a strong argument that the additional costs of the written opinion are relatively small (the filing fee for employment arbitrations with the NASD is \$600 and "forum fees" charged to the claimant much higher) compared to the accrued benefits of the new practice—greater accountability of arbitrators, claimant's increased belief in the fairness of the arbitral process, ability of claimants to change their future behavior to avoid additional legal difficulty, and ability of either party to present an effective appeal. Given the added benefits of the reasoned opinion requirement in terms of decision maker accountability, a court applying the Due Process Clause should find that a written opinion that offers a reasoned explanation of the outcome is required.

Conclusion

The close relationship between the SEC and the SROs creates state action when the SROs mandate that their employees participate in arbitration as a condition of their employment. Long before the SEC created the requirement that all brokerage employees register with the SEC, the SEC participated actively in developing rules and procedures governing the SRO arbitration process. Moreover, the SEC encouraged

190. NASD Proposed Rule Change, *supra* note 178.

191. Justin Kelly, *NASD Proposes Plan to Require Written Awards on Request*, ADR WORLD, Feb. 9, 2005, available at <http://www.adrworld.com/sp.asp?id=27383>.

192. *Id.*

193. *Id.*

and continues to encourage SROs to utilize arbitration as the primary means for resolving employment disputes. In effect, the SEC is implicitly mandating participation in arbitration through the combination of its registration requirement and its approval and encouragement of the use of arbitration.

The presence of state action in securities arbitration mandates reform of the securities arbitration process. While other changes may be necessary, at the very least, two major alterations are necessary. First, when parties enter peremptory challenges of arbitrators for discriminatory reasons, the party affected by the illicit challenge has a right to challenge the arbitration award. Second, and perhaps more significant, a party's employment claim is entitled to the appropriate amount of procedural due process before the state (here, the SRO) may deprive the individual of the claim. While the securities arbitration process largely comports with due process, one glaring omission is the lack of well-reasoned written opinions. Applying the cost-benefit analysis the Court established in *Mathews v. Eldridge*, a court would weigh the cost of adding reasons to the written opinions against the benefits achieved by the new requirement.¹⁹⁴ Requiring well-reasoned opinions would dramatically increase arbitrators' accountability. Increased accountability should result in a "better" opinion—better reasoned and more carefully considered. Given the limited increase in cost of requiring a well-reasoned written opinion, the benefits that would accrue in terms of accountability and public perception of the fairness of the securities arbitration process clearly demonstrate the importance of requiring a well-reasoned opinion. Because the Due Process Clause applies to securities arbitration, the well-reasoned opinion requirement should be quickly implemented. While this may appear to be a small improvement in the process, in fact, it is likely to reap huge dividends for all involved in the project of securities arbitration reform.

Importantly, requiring a well-reasoned written opinion in industry arbitrations may have a broader salutary effect. As a political matter, it would be extremely difficult for the SROs to provide greater due process to employees in arbitration with their SROs than to customers. Thus, even if the Due Process Clause does not demand a well-reasoned written opinion in the customer-broker relationship (because arbitration between customers and brokers is not mandatory), a change in industry arbitrations would likely be extended to customer arbitrations as well.

194. *Mathews v. Eldridge*, 424 U.S. 319, 335, 348 (1976).

